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No. 98-2043

In The

Supreme Court of the United States

HUNT-WESSON, INC.,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Writ Of Certiorari
To The Court Of Appeal Of California
For The First Appellate District

BRIEF OF *AMICI CURIAE* STATES OF IDAHO, ALASKA, MONTANA, AND NORTH DAKOTA IN SUPPORT OF RESPONDENT

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I. INTEREST OF *AMICI CURIAE*

This brief is submitted by the State of Idaho as *amicus curiae* in support of the respondent in *Hunt-Wesson, Inc. v. Franchise Tax Board*. Other States join this brief as *amici* to preserve the flexibility and diversity of practice they now enjoy in assigning interest expense to nonbusiness income.

Idaho also has a special interest in this case. Until 1998, Idaho had a statute, similar but not identical to California's Rev. & Tax. C. § 24344(b), that provided for an offset of interest expense against nonbusiness income.[1]

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[1] Former Idaho Code § 63-3022(a)(2) provided:

> In the case of a corporation whose Idaho taxable income is computed pursuant to section 63-3027, Idaho Code, the interest expense deductible shall be an amount equal to interest and dividend income subject to apportionment, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income not subject to apportionment. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income not subject to apportionment. This provision shall not apply to dividend income excluded pursuant to section 63-3027C(c) and (e), Idaho Code.

As used in the quoted statute, income subject to apportionment is business income; income not subject to apportionment is nonbusiness income. The first cross-reference, to § 63-3027, refers to combined reporting and the Idaho version of the Uniform Division of Income for Tax Purposes Act (UDITPA), so that the quoted statute applies to single corporations and unitary corporate groups that operate in more than one state. The final cross-reference, to § 63-3027C, refers to a "water's edge" election, whereby a corporation can elect not to be taxed

The Idaho provision was repealed, effective January 1, 1998.[2] There is now pending in the Idaho Supreme Court a case in which, *inter alia,* Union Pacific Corporation challenges the constitutionality of Idaho's former statute.[3] This Court's decision in this matter will substantially affect the outcome of the Idaho litigation on that issue.

Effective January 1, 1998, the Idaho Code was amended by adding new language that requires "related expenses" to be offset against nonbusiness income.[4] For 1998 and later years, Idaho joins the other State *amici* in their common interest in retaining flexibility to assign

on certain income from foreign sources. The inapplicability of interest offset to such excluded foreign income is not an issue in *Hunt-Wesson.*

[2] H.B. No. 541, 1998 Sess. Laws, ch. 42, § 2, p. 176.

[3] *Union Pacific Corp. v. Idaho State Tax Comm.,* No. CV OC 97104812D (4th Dist., Ada County, judgment entered Aug. 11, 1999), *docketed as* Nos. 25876 & 25882 (Idaho Sup. Ct., State's appeal filed Sept. 21, 1999 and Union Pacific's appeal filed Oct. 6, 1999).

[4] The new language added at the end of Idaho Code § 63-3027(d) provides:

> Allocable nonbusiness income shall be limited to the total nonbusiness income received which is in excess of any related expenses which have been allowed as a deduction during the taxable year. In the case of allocable nonbusiness interest or dividends, related expenses include interest on indebtedness incurred or continued to purchase or carry assets on which the interest or dividends are nonbusiness income.

The language was added by H.B. No. 541, 1998 Sess. Laws, ch. 42, § 5, p. 182.

interest expense to nonbusiness income free from a constitutional prohibition of any specific formula.

II. SUMMARY OF ARGUMENT

In Cal. Rev. & Tax. C. § 24344(b), for the purpose of assigning a corporation's interest expense to nonbusiness dividend and interest income, California classifies recipients of dividends based on whether they use debt or equity to finance their passive, nonbusiness investments. California allows interest expense to be deducted first against business interest income, and later against all other business income; but in between these layers of deduction, it requires that nonbusiness dividend and interest income be assigned a share of the taxpayer's interest expense.

Petitioner concedes that it would not raise constitutional challenges if California assigned interest expense to nonbusiness dividends using an unspecified formula, such as those used by the Internal Revenue Service and various states, that petitioner considers "fair." Petitioner thus impliedly agrees that its nonbusiness dividends bear an economic relation to its interest expense. But petitioner objects to California's particular assignment method. The dispute therefore is over exactly how to associate the expense with the income.

In the apportionment formula area, this Court has refrained from mandating or prohibiting any particular apportionment formula under the Constitution. *Moorman Mfg. Co. v. Bair,* 437 U.S. 267 (1978); *Container Corp. of America v. Franchise Tax Bd.,* 463 U.S. 159 (1983). There is

no single correct way to assign interest expense to nonbusiness income. It is the lack of uniformity – in particular, Illinois' lack of an interest offset statute – that is the cause of petitioner's grievance. The Court should leave the allocation of interest to the states just as it leaves apportionment formulas to the states, except in the rare case where the result is grossly distorted. *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931).

Money used to fund nonbusiness investments is fungible with operating funds. Applying the tests of fairness of apportionment formulas laid down in *Container Corp., supra,* California's formula based on fungibility reflects a reasonable sense of how petitioner's interest and dividend income is generated, and is therefore externally consistent. California's formula is also internally consistent because if Illinois adopted California's provision, petitioner's income would only be taxed once.

Expenses are typically not susceptible of precise division, either among taxing states (which makes separate accounting for net income impracticable) or among entities in a unitary group (when the expenses are part of unitary contributions to value), let alone among different streams of income received by a corporation. This Court permits a state to treat an expense that occurs only outside its borders as an expense of earning unitary income and as apportionable to the state. The state in such a case may deny a deduction for the out-of-state expense in a nondiscriminatory manner. *Amerada Hess Corp. v. Director, Div. of Tax.*, 490 U.S. 66 (1989). If a deduction can be denied, then it can also be reassigned to a different class of income, as here.

Refuting petitioner's first discrimination claim, § 24344(b) is neutral on its face and makes no mention of a corporation's domicile. Petitioner has shown no discriminatory intent on California's part. The classification in § 24344(b) is based on debt financing, which is unrelated to location, and nonbusiness income, which can arise anywhere. *Amerada Hess, supra.* There is no facial discrimination.

Petitioner's second claim of discrimination is based on the cross-reference in § 24344(b) to Cal. Rev. & Tax. C. § 24402, which excludes from the recipient's gross income dividends paid from income previously subject to California franchise tax in the hands of the paying corporation. Since the constitutionality of § 24402 is not directly in issue here, this Court should refrain from passing on it until the California courts have had an opportunity to interpret § 24402 in the first instance. In any event, § 24402 is narrowly tailored to prevent double taxation by California, which is a legitimate state objective not passed upon in the superficially similar case of *Kraft General Foods, Inc. v. Iowa Dep't of Rev. & Fin.*, 505 U.S. 71 (1992). And unlike the facts of *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), § 24402 coordinates the burdens of a single tax – the California franchise tax – and not two taxes on different bases, which was the case in *Fulton*. Section 24402 is a valid compensating tax.

The interest offset under § 24344(b) is inapplicable to dividends that are paid from income previously taxed by California in the hands of the dividend paying company. But the favorable treatment of such dividends in § 24344(b) is offset or cured by Cal. Rev. & Tax. C.

§ 24425, which provides for an offset of related or attributable interest against income excluded from the franchise tax. Read together with § 24425, § 24344(b) is neutral as between dividends from previously taxed California income and dividends from other income.

III. ARGUMENT

A. As with apportionment formulas, the Court should not "constitutionalize" a particular method of assigning interest expense

Petitioner questions the power of a taxing state to reclassify a deduction claimed by a unitary business for expenses. The problem can be analogized to the treatment in this Court's cases either of apportionment formulas or apportionability of items of income.

The unitary business principle and formula apportionment are two aspects of the principle that "a State may not tax value earned outside its borders." *ASARCO, Inc. v. Idaho St. Tax Comm.*, 458 U.S. 307, 315 (1982); *Container Corp.*, 463 U.S. at 164. Petitioner argues that California by § 24344(b) effectively taxes income that lies outside California's taxing power, (Pet. Br. 18), and that is "taxable by Illinois." (Stip. ¶ 8 (J.A. 19); J.A. 55 n. 3 (Court of Appeal opinion))[5] There is an analogy between a

[5] Petitioner carefully refrains from asserting that the dividends were actually taxed in full as nonbusiness income by petitioner's domicile state of Illinois. There is no evidence that petitioner actually reported the dividends as nonbusiness income in its Illinois tax returns.

formula to assign interest expense to income in arriving at net income and a formula to apportion net income among the states. This Court's three major cases on apportionment shed light on the interest formula question.

The first of these is *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931). There, a company manufactured goods in North Carolina, which used a single-factor apportionment formula consisting of the ratio of in-state property to total property, resulting in a North Carolina ratio of 83%. All of Hans Rees' output was sold through a New York office and warehouse to customers worldwide. Hans Rees put in evidence a separate accounting that showed that 17% of its income was earned in North Carolina. This Court struck down the North Carolina formula as applied to Hans Rees, holding that it was "unreasonable and arbitrary" in application "in attributing to North Carolina a percentage of income out of all appropriate proportion to the business transacted by the appellant in that State." 283 U.S. at 133 & 135.

The second case was *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978), involving a converse factual situation from *Hans Rees*. Moorman's factory was in Illinois, which used the three-factor formula of property, payroll and sales. Moorman sold about 20% of its output across the state line in Iowa, which employed a single-factor formula consisting of the ratio of Iowa sales to total sales. Moorman challenged the Iowa formula, alleging that Iowa was taxing Illinois income. This Court upheld the Iowa formula, noting the lack of a separate accounting of "actual income in Iowa" (437 U.S. at 275 n.9). The Court stated:

[W]e do not know whether Illinois and Iowa together imposed a tax on more than 100% of the relevant net income. . . .

Even assuming some overlap, we could not accept appellant's argument that Iowa, rather than Illinois, was necessarily at fault in a constitutional sense. It is, of course, true that if Iowa had used Illinois' three-factor formula, a risk of duplication in the figures computed by the two States might have been avoided. But the same would be true had Illinois used the Iowa formula. . . .

. . . The asserted constitutional flaw in [Iowa's] formula is that it is different from [the three factor formula] presently employed by a majority of States and that difference creates a risk of duplicative taxation. But a host of other division-of-income problems create precisely the same risk and would similarly rise to constitutional proportions.

Thus, it would be necessary for this Court to prescribe a uniform definition of each category in the three-factor formula. . . . A similar risk of multiple taxation is created by the diversity among the States in the attribution of "nonbusiness" income. . . .

The prevention of duplicative taxation, therefore, would require national uniform rules for the division of income. . . . The Constitution, however, is neutral with respect to the content of any uniform rule. If division-of-income problems were to be constitutionalized, therefore, they would have to be resolved in the manner suggested by appellant for resolution of formula diversity – the prevalent practice would be endorsed as the constitutional rule. . . .

437 U.S. at 276-279 (footnotes omitted). (The third case in the series is *Container Corp., supra,* discussed below in subheading D.)

Petitioner here asks the Court to partially "constitutionalize" the interest allocation issue by prohibiting California's particular formula. Petitioner's brief in the Court of Appeal in hypothetical examples alleged the double taxation of nonbusiness dividends by both Illinois and California.[6] But petitioner has never made such a factual assertion, and carefully couched its double taxation argument in hypothetical terms only. Like Moorman, petitioner has not shown that the nonbusiness dividends were in fact taxed twice.

Also as in *Moorman*, petitioner's challenge would be moot if Illinois had an identical law, for then the interest expense would be allocated by both states to only one state – Illinois – and petitioner would retain the full benefit of its interest deduction. As in *Moorman*, the constitutional fault, if there is one, may be laid either at California's door or those of the other states. This Court can grant the relief requested only by "constitutionalizing" one or more of the formulae that petitioner characterizes as "fair." Just as this Court refused to "constitutionalize" a particular apportionment formula in *Moorman*, the Court should refuse to do so here. The Constitution does not require or prohibit any particular formula to assign interest expense to nonbusiness dividends.

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[6] Respondent's Reply Brief, p. 12, in the California Court of Appeal (March 18, 1998).

On the other hand, taxpayers should be protected from an assignment of interest expense "out of all appropriate proportion" to the nonbusiness income, *Hans Rees*, 283 U.S. at 135, or an assignment that leads to "a grossly distorted result," *Norfolk & Western R. Co. v. State Tax Comm'n*, 390 U.S. 317, 326 (1968). The petitioner has offered no such evidence in this case.

B. Petitioner's interest expense is related to the nonbusiness dividends because the loan proceeds freed up equity capital for nonbusiness investments

Conceptually, the possible degrees of relationship between petitioner's interest expense and its nonbusiness dividends can be arranged in a hierarchy or continuum of relatedness, from direct traceability to complete lack of connection. The relationship between interest expense and dividend income here at issue falls between the two poles of relatedness.

• *Not a purchase money borrowing.* The hierarchy starts with a direct link between the interest expense and the dividend income. There is no evidence in the record that Beatrice borrowed money specifically to acquire or hold one or more of the dividend paying subsidiaries. Nor is there evidence that the debt was used for any other narrow purpose. The debt is therefore unlike an individual's purchase money mortgage secured by a home. It also differs from the leveraged buyout situation, where a target company's assets are pledged to secure the acquirer's borrowing.

As will become clearer as we proceed along the continuum, the lack of a direct connection does not mean that the interest expense and the dividend income are completely unrelated to each other.

• *No "direct tracing."* Beatrice did not make direct operating loans to its foreign subsidiaries. Each foreign subsidiary was directly responsible for its own borrowings. (Stip. ¶ 9 (J.A. 19)) The monies borrowed by Beatrice were not passed through to the foreign subsidiaries to fund their current operations or borrowings.

• *Fungibility, part I: Indirect relationship subject to proration by formula.* The stipulated facts do not show a direct relationship of petitioner's interest expense to any particular income. Petitioner's brief states that "none of that interest expense bore any *direct* relationship to the production of the exempt income." (Pet. Br. 20, emphasis added) Petitioner's careful phrasing must mean that there is an "indirect" relationship.

Since no direct tracing is possible, California could have attempted to apply what petitioner refers to as "reasonable methods of fairly allocating interest expense between various classes of income." (Pet. Br. 27) Petitioner admits that had a formula allocation of interest expense been applied, then "petitioner would not be here." (Pet. Br. 23) Petitioner thus concedes an "indirect" relationship between the interest expense and the dividend income, sufficient to support an unspecified formulaic allocation of the one to the other.

• *Fungibility, part II: Interest offset based on fungibility of cash.* In support of § 24344(b), the California Supreme Court suggested that a corporation's money is fungible,

so its funds from all sources contribute to all of its activities:

> [O]therwise there may be a loophole. A foreign corporation could avoid all taxes in California merely by increasing its borrowing to create an interest deduction and then purchasing stocks which pay dividends.

Pacific Tel. & Tel. Co. v. Franchise Tax Bd., 7 Cal. 3d 544, 554, 498 P.2d 1030, 1037 (1972). The broader theory of the California Supreme Court is that borrowed money and equity capital are fungible with each other.

The Constitution should permit a state to associate interest expense with dividend income if the fungibility of money permits the inference that borrowed money was substituted for equity and used for business purposes, freeing up the taxpayer's equity capital for nonbusiness investments. More will be said about this theory below, after discussing the last rung of the hierarchy of relationships.

- *The straw man position: Zero relationship, with no assignment of interest expense.* Petitioner argues repeatedly that there is no relationship whatever between the interest expense and the nonbusiness dividends.[7] Despite petitioner's protestations, this "zero" level of relationship is not the fact pattern before us now.

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[7] *E.g.*, Pet. Br. i ("unrelated"), 2 ("no relationship"), 14 (no "purported relationship"), 16 ("facts do not reveal any relationship"), etc.

The trial court stated:

> [I]t appears that no portion of the interest expense deduction can be attributable to the generation of the . . . exempt dividends, [because] no portion of the proceeds of the loans generating the interest expense deductions herein went to any non-unitary corporation. . . .

(J.A. 45) The trial judge evidently made his "no attribution" finding using a "direct tracing" standard. But he did not consider, let alone consider and dismiss, possible standards of indirect relatedness based on either proration by formula or fungibility of cash. The Court of Appeal reversed, based on the California Supreme Court's *Pacific* decision, which used a fungibility rationale.

Petitioner concedes some degree of relationship between the interest expense and the dividend income. Petitioner admits it would accept a "fair," "reasonable" allocation of interest expense to the dividend income; this "would obviate the constitutional issues raised by this case." (Pet. Br. 26) There is no reason for petitioner to accept a formula allocation if there is in fact zero relation between the interest expense and the dividend income. Petitioner's acceptance of a formula allocation is an admission *sub silentio* that the dividend income and the interest expense are rationally connected.

The bottom of the hierarchy – the complete absence of a relationship between the interest and the dividends – is not the case before us. *National Life Ins. Co. v. U.S.*, 277 U.S. 508 (1928) is not on point. The posture of "zero relationship" diverts attention from the real issues.

Fungibility is a useful analytical model because credit gives individuals and businesses financial flexibility they would not otherwise have. This is true even where the use of borrowings can be traced to specific purchases. In the case of individuals, if there were no home mortgages, the amount of money invested by individuals in today's stock market would be dramatically reduced. Equity savings freed up by home lending become available to be invested elsewhere.

All publicly traded companies are required by the Securities and Exchange Commission (SEC) to publish, in their annual reports, financial statements including a statement of cash flows.[8] A cash flow statement accounts for all increases and decreases in the cash of the corporation during the year. Operating, financing, and investing cash flows are grouped together, and a single bottom line shows the net increase or decrease in cash. The cash flow statement graphically illustrates that cash is fungible and passes freely between business and nonbusiness uses. The fungibility of cash is a reality of the business world.

C. The difficulty of tracing expenses underlies both the unitary business principle and California's ordering formula

After apportionment formulas, a major concern of this Court's unitary tax jurisprudence is the apportionability of dividend income. Dividend income can be

[8] 17 C.F.R. §§ 210.3-02 & .12-04 (1999). Annual reports are available from the SEC, on companies' Web sites, and in most public libraries.

apportioned to a taxing state only if the dividend income is either part of the taxpayer's unitary business conducted in the taxing state or is earned in an operational function of the taxpayer. *Allied-Signal, Inc. v. Director, Div. of Tax.*, 504 U.S. 768, 787 (1992). One might invert that principle and hold that a state is obliged to allow a deduction for an expense incurred in the course of the unitary business or in an operational function, but not for other (nonbusiness) expenses. But applying such a rule to interest expense requires some form of tracing of the use of borrowed funds. Unlike an item of receipts, the origin of which is traceable to a specific outside customer or investment asset, funds used to pay expenses are commingled with the fungible cash of the business. Tracing them requires the use of one or more assumptions, the choice of which is usually arbitrary.[9]

Expense allocation is one reason for "the impossibility of allocating specifically the profits earned by the processes conducted within [a state's] borders," *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 121 (1920). The difficulty of tracing the impact on each store's expenses of a centralized purchasing operation underlay the early unitary case of *Butler Bros. v. McColgan*, 315 U.S. 501 (1942). Common expenses are a hallmark of a unitary business, and a major reason for adopting the unitary business principle in the first place. Here, to attempt to assign expenses to specific items of income within a

[9] Compare the calculation of the cost of goods sold by a business, using an assumption that fungible goods in a commingled inventory are sold in a particular order, such as first-in, first-out or last-in, first-out.

unitary business would invite problems similar to those of separate accounting within state borders.

This Court has stated that even when an expense can be traced to an activity that occurs only outside the taxing state, if the expense is a cost of producing unitary income, a taxing state may constitutionally treat it as an in-state expense, deny a deduction for it, and apportion the resulting net income. *Amerada Hess Corp. v. Director, Div. of Tax.*, 490 U.S. 66 (1989). Here, conversely, even if petitioner were correct in tracing the interest expense exclusively to business income, California may reclassify the deduction in a nondiscriminatory manner by assigning it to nonbusiness income.

Given the business reality that borrowed funds are fungible with equity funds, California first allows a deduction for interest expense to the extent of apportionable business interest income.[10] Only then is fungible interest expense applied against nonbusiness interest and dividend income.[11] Finally, all remaining interest is deducted from all other apportionable business income.[12] California's three-tiered approach is supported by this Court's decisions.

[10] Amounts in this first layer of deductions are shown at Pet. Br. 10.

[11] Amounts in the second layer are at Pet. Br. 11, carryover paragraph.

[12] Amounts in the third layer are shown in Pet. Br. 11, n. 11.

D. The California formula based on fungibility reflects a reasonable sense of how petitioner's income is generated and is externally consistent

Returning to this Court's cases on apportionment formulas, we consider *Container Corp., supra*. Container, a multinational manufacturer, asserted *inter alia* that its property and payroll in foreign countries were more productive than those in California, hence California's use of raw property and payroll figures in the apportionment formula overstated Container's California income. The Court denied relief, holding that California's formula, while "necessarily imperfect," was

> certainly within the substantial margin of error inherent in any method of attributing income among the components of a unitary business.

463 U.S. at 183 (citations omitted). The assignment of interest expense to dividend income is a step in the process of "attributing income among the components of a unitary business" and should be subjected to the same level of constitutional scrutiny as an apportionment formula.

Container laid down two tests of fairness of an apportionment formula under the Due Process and Commerce Clauses:

> The first . . . component of fairness in an apportionment formula is what might be called internal consistency – that is the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business's income being taxed. The second and more difficult requirement is what might be called external consistency – the factor or factors

> used in the apportionment formula must actually reflect a reasonable sense of how income is generated. . . .

463 U.S. at 169.

As to external consistency, the Court evidently was more comfortable with a three-factor formula of property, payroll and sales than it was with the single-factor property formula in *Hans Rees*. The Court found single-factor formulas to be

> particularly problematic because they focus on only a small part of the spectrum of activities by which value is generated. . . .

On the other hand, the three-factor formula

> has gained wide approval precisely because payroll, property, and sales appear in combination to reflect a very large share of the activities by which value is generated. . . .

463 U.S. at 182-183.

Applying this analytical structure to the present case, petitioner's willingness to accept an unspecified, "fair" formula method in effect concedes that money is fungible. The fungibility of money reflects a reasonable consensus about how income is generated. Taking it a step further, it is reasonable to equate passive, recurring income such as dividends and interest with the regular expense of interest, as the California Supreme Court did. *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 7 Cal. 3d 544, 555, 498 P.2d 1030, 1038 (1972). A taxpayer can normally be expected to use its dividend and interest income to defray its interest expense. From a cash flow perspective,

the receipts go into a single "pot" and the interest is paid from that "pot."

California's tiered system of assigning interest expense in sequence, first to business interest income, then to nonbusiness income, and lastly to other business income, reflects a reasonable sense of how income is generated. It is externally consistent.

E. California's interest offset statute is internally consistent

Even if § 24344(b) causes petitioner effectively to lose the California tax benefit of its nonbusiness income, if petitioner's domicile state of Illinois were to adopt an equivalent of § 24344(b) (or if petitioner were domiciled in Idaho, which had such an equivalent during the tax years in dispute here), then petitioner would gain a tax benefit in Illinois (or Idaho) equivalent to that lost in California. Internal consistency requires nothing more. The California statute is internally consistent.

F. California's interest offset statute (without regard to the parenthetical exception for dividends from previously taxed income) is facially neutral

In its part II, petitioner raises two challenges to § 24344(b) alleging discrimination. The first challenge is that § 24344(b) discriminates against interstate commerce by denying interest deductions only to nondomiciliary corporations.

Section 24344(b) on its face does not mention a corporation's domicile. In this respect, it resembles the New Jersey statute that this Court upheld in *Amerada Hess Corp., supra*. There, New Jersey's corporate income tax statute disallowed a deduction for "[t]axes paid or accrued to the United States on or measured by profits or income," which denial was held by the New Jersey Supreme Court to extend to the federal Crude Oil Windfall Profit Tax. Although no oil is produced in New Jersey, this Court found that the statute was not facially discriminatory, since it also denied a deduction for the federal income tax. 490 U.S. at 76-77. The Court stated:

> [I]n the absence of discriminatory intent or a statute directed specifically at economic activity that occurs only in a particular location . . . , a deduction denial does not unduly burden interstate commerce just because the deduction denied relates to an economic activity performed outside the taxing State.

490 U.S. at 78 n.10 (citation omitted). Here, petitioner cites no evidence of discriminatory intent on California's part. Nonbusiness income, like the expense of the federal income tax, can arise anywhere, without geographic limitation. Without regard to the parenthetical language that cross-refers to § 24402 (discussed in subheadings H, I, and J below), the California statute is facially neutral.

G. California's interest offset statute (without regard to the parenthetical exception for dividends from previously taxed income) does not discriminate in practical operation

Petitioner also sees discrimination in the practical effect of the statute. This Court's apportionment formula cases again furnish a helpful analogy. In *Moorman, supra*, Iowa employed an apportionment formula consisting of the ratio of Iowa sales to total sales, while most other states, including Moorman's home state of Illinois, employed the three-factor formula of property, payroll, and sales.

On that fact pattern, suppose two companies otherwise equally situated, as follows: Company A is Moorman, with its factory and offices in Illinois, selling primarily into states other than Illinois, including Iowa. Company B is Moorman's hypothetical competitor, but with its factory and offices in Iowa and selling primarily into states other than Iowa, including Illinois.

Because Illinois employs property and payroll in its formula, its law will attract more Illinois tax to Illinois-based companies than to similarly situated companies not based in Illinois. Illinois' three-factor formula disadvantages locally based companies; it disadvantages Moorman compared to Company B. Conversely, Iowa's formula disregards headquarters and plant that would be represented by property and payroll. Iowa bases its apportionment only on sales. Company B, primarily an exporter from Iowa, will pay less tax in Iowa than Moorman, a nondomiciliary company selling into Iowa. The Iowa law advantages local companies and disadvantages out-of-

state companies. Any company whose sales are primarily outside its home state will have an incentive to locate its plant and headquarters in Iowa as opposed to a three-factor state. This is a differential treatment in practical effect. Yet this Court in *Moorman* sustained Iowa's formula, holding that any discrimination was a consequence of a lack of uniformity. 437 U.S. at 277 n.12.

California's statute is even more benign than that in *Moorman* because the classification here is based on how the taxpayer finances itself. The Commerce Clause is not violated when the differential tax treatment of two categories of companies "results solely from differences between the nature of their businesses, not from the location of their activities." *Amerada Hess*, 490 U.S. at 78 (citation omitted). A spillover effect of § 24344(b) on nondomiciliaries is a natural consequence of a classification based on debt financing of passive investments, just as the spillover effect of Iowa's apportionment formula is a natural consequence of a constitutionally acceptable variation in apportionment philosophy. Neither consequence is of constitutional dimension.

This Court has also stated that allegations of discrimination may be refuted by showing that the tax is fairly apportioned. The third (anti-discrimination) prong of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977) "has not in practice required much in addition to the requirement of fair apportionment." *Container Corp.*, 463 U.S. at 171. Fair apportionment may offset and cure alleged discrimination. Petitioner has not challenged the apportionment formula applied by California. As argued

above, California's statute is both externally and internally consistent. There is therefore no discrimination cognizable by this Court in § 24344(b), without regard to the parenthetical language, to which we turn next.

H. The parenthetical exception to § 24344(b), for dividends from income previously taxed by California, is a narrowly tailored means to prevent double taxation

In part III of its brief, petitioner attacks § 24344(b) as discriminatory based on the parenthetical language reading, "(except dividends deductible under Section 24402)." Rev. & Tax. C. § 24402 allows a recipient a deduction for dividends declared from income that has been "included in the measure of the [California franchise] tax[ ]. . . ."[13] Since the constitutionality of § 24402 is not directly in issue here, this Court should refrain from passing on it until the California courts have had an opportunity to interpret § 24402 in the first instance.

• *Mechanics of § 24402*. To illustrate how § 24402 works, suppose Company S in year 1 has business income of $100 and no nonbusiness income, and a California apportionment factor of 25%. Thus, $25 of Company S's income is subject to California's franchise tax, and Company S pays that tax. On January 1 of Year 2, Company S pays $40 in dividends to its shareholders.

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[13] Idaho's equivalent to California's § 24344(b) was former Idaho Code § 63-3022(a)(2), quoted in note 1, *supra*. Idaho has no equivalent to California's § 24402. Subheadings H, I, and J of this Argument are not applicable to Idaho.

Company P owns 10% of Company S and so receives \$4 in dividends. Company P is taxable in California. Without § 24402, Company P would report the \$4 as gross income in California. By application of § 24402, Company P may deduct up to \$1 of the dividend,[14] reporting \$3 as income in California. The \$1 deduction adjusts for the tax that Company S paid on 25% of its pretax income in Year 1. California has already taxed Company S and so gives partial relief to Company P.

- *§ 24402 prevents double taxation.* There are surface similarities between § 24402 and the Iowa provision held unconstitutional in *Kraft General Foods, Inc. v. Iowa Dep't of Rev. & Fin.*, 505 U.S. 71 (1992). That case, however, is not on point.

Kraft involved an Iowa income tax statute that allowed a deduction to a corporation for 100% of dividends received from subsidiaries that were incorporated in the United States and in which the payee corporation owned more than 80% of the stock. Iowa did not allow a similar deduction if the dividend payor was incorporated

[14] The actual percentage of P corporation's allowable deduction will vary depending on how much stock P owns in S. If P owns more than 50% of S, then the deduction is 100% of the \$1; if 20% or more up to 50%, then the deduction is 80 cents (80% of the \$1); if less than 20%, the deduction is 70 cents (70% of \$1). The stepped-down percentages were presumably borrowed from Internal Revenue Code § 243. As the stepped-down percentages do not affect the constitutional analysis so far as your *amici* are aware, the example in the text assumes that P gets a deduction of \$1.

in a foreign country. This Court struck down the Iowa deduction as facially discriminatory.

Iowa did not argue that its deduction was intended to prevent double Iowa taxation of the income of Kraft's domestic subsidiaries, and this Court did not pass on the question whether avoidance of such double taxation would be a justification sufficiently compelling to support the challenged statute.[15] Here, unlike *Kraft*, the tax deduction is narrowly tailored to avoid double taxation by California. Avoidance of double taxation is a proper objective of state taxation, and your *amici* see no less burdensome means of achieving that objective.

I. The parenthetical exception to § 24344(b) is a valid compensatory tax

There is also a superficial resemblance between § 24402 and the North Carolina provision held unconstitutional in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996). But like *Kraft*, *Fulton* is not on point.

Fulton involved the North Carolina "intangibles" tax on the value of stock held by North Carolina resident shareholders. The challenged statute allowed a deduction of value from the tax base equal to the percentage of the issuing corporation's income that was subject to the North Carolina income tax. This Court struck the intangibles tax down as facially discriminatory. The Court found that the intangibles tax and the corporate income

[15] The benefit of avoiding double taxation was alluded to only in the dissenting opinion of Rehnquist, C.J., 505 U.S. at 86.

tax were so different that the former could not be viewed as compensating for the latter. Even though the value of a corporation's stock might be directly affected by the amount of North Carolina income tax that the corporation paid, the burden of the two taxes fell on different classes of people (corporations versus shareholders), and their different rates (7.75% for income, .25% on value of stock) did not assure that out-of-state companies were subject to equal or lower tax overall than local companies. 505 U.S. at 337-340.

Unlike the provisions in *Fulton*, § 24402 coordinates the impact of the California corporate franchise tax (one tax as opposed to two in *Fulton)* between the dividend paying corporation and the recipient corporation. Section 24402 therefore should survive a facial challenge as a compensatory or complementary tax. *Associated Indus. of Mo. v. Lohman*, 511 U.S. 641 (1994).

Again, the constitutionality of § 24402 is not directly in issue here. The Court should refrain from passing on its constitutionality until the California courts have an opportunity to interpret it in light of current constitutional jurisprudence.

J. Even with the parenthetical exception included, § 24344(b) does not discriminate

An allegedly discriminatory tax provision must be evaluated in the context of the entire taxing system, for defects in one area may be offset or cured by other provisions. *Washington v. U.S.*, 460 U.S. 536, 542 (1983).

Returning to our hypothetical example, the parenthetical language in § 24344(b) removes the deducted $1 portion of Company P's $4 dividend from the § 24344(b) interest offset computation. Assuming the dividend from S is nonbusiness income to P, and that P has ample interest expense, then at least under § 24344(b) only $3 of interest expense will be assigned to the S dividend, increasing P's apportionable income to that extent, while the excluded $1 of the S dividend has no effect on P's apportionable income.

Petitioner looks at §§ 24402 and 24344(b) in isolation and sees a fatal discrimination, giving favorable treatment to the $1. But the separate offset provision of § 24425 cures this problem. Section 24425 denies a deduction for

> [a]ny amount otherwise allowable as a deduction which is allocable to . . . income not included in the measure of the tax.

By operation of § 24425, the $1 portion of the dividend will also attract interest expense. To the extent there is interest expense directly traceable to the S dividend, or fairly associable with it by a formula method, then up to $1 of interest expense will be applied to offset the excluded $1. *Great Western Fin. Corp. v. Franchise Tax Bd.*, 4 Cal.3d 1, 479 P.2d 993 (1971). Thus, California offsets dividends from companies having income taxed by California equally with dividends from other companies. Sections 24344(b), 24402, and 24425, taken together, form a nondiscriminatory system.

IV. CONCLUSION

Section 24344(b) passes constitutional muster. The decision of the California Court of Appeal should be affirmed.

Respectfully submitted,

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